DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0721
Income Tax
For Tax Periods 1994-1996

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ISSUES

I. Income Tax—Combined Filing

Authority: ANR Pipeline v. Indiana Department of State Revenue, 672 N.E.2d 91 (Ind.Tax 1996); IC 6-3-2-2; IC 6-8.1-4-2; 45 IAC 3.1-1-62

Taxpayer protests the denial of permission to file a combined return.

II. Tax Administration—Negligence Penalty

Authority: 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is the parent company for numerous corporations engaged in the publishing and broadcasting business. One of these corporations is in business as a television station in Indiana. Another of the corporations is in business as a television station in a neighboring state, with its transmission towers located in Indiana. In 1995, the second corporation purchased and began operating an independent television station in Indiana. These are the only two members of the parent company's affiliated group that have an Indiana business situs or any activities in Indiana subjecting them to Indiana taxation.

In 1994, taxpayer sought the Indiana Department of State Revenue's ("Department") approval to file a combined return in Indiana. The Department approved the combined return, contingent on several factors. The Department conducted an audit in 1998, which resulted in denial of permission to file a combined return. Taxpayer protests this denial.

I. Income Tax—Combined Filing

DISCUSSION

Taxpayer protests the Department's retroactive denial of permission to file a combined return. The denial resulted from an audit covering the years 1994 through 1996, in which the Department found what it believes was a material error in taxpayer's petition to file a combined return. The material error referred to by the Department was taxpayer's assertion that combined filing was necessary to accurately reflect taxpayer's Indiana income. Taxpayer believes the audit report did not provide adequate explanation of why the combined return was disallowed.

The Department's March 19, 1994 letter to taxpayer approved its request to file a combined return, but listed several contingencies on that approval. Contingency number five (5) states, "This approval is subject to revocation if the facts subsequently established by the Department disclose material error or misrepresentation to the facts set forth in this petition." The Department conducted an audit for the tax years at issue, and concluded that combined filing was not necessary to fairly reflect taxpayer's Indiana income.

The Department's approval letter stated that the Department agreed that the companies concerned did meet the major tests to be considered a unitary group. The approval letter also explains that Indiana law imposes one additional hurdle, in that a unitary return should only be used if the adjusted gross income attributable to Indiana cannot be fairly reflected through some other method. Taxpayer believes that significant intercompany transactions make it necessary to file a combined return to accurately reflect Indiana income. The audit report explains that the existence of the intercompany transactions does not constitute proof that Indiana income cannot be fairly reflected by standard allocation and apportionment provisions.

The audit report explains that the combined filing was disallowed under the authority of 45 IAC 3.1-1-62, which states:

> Special Formulas for Division of Income. All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) *[45 IAC 3.1-1-37—45 IAC 3.1-1-61]* unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

Taxpayer asserts that standard allocation and apportionment provisions do not fairly reflect the Indiana income for the unitary group. The standard formula is described in IC 6-3-2-2(b), which states in part:

> Except as provided in subsection (*l*), if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, the denominator of which is three (3).

The parent company provides services such as strategic planning, securing corporate debt, cash management, financial reporting, tax services and risk management to its subsidiaries. The parent contends that it is unable to properly allocate the expenses associated with these services to its subsidiaries. Taxpayer believes that the companies in question do form a unitary group, therefore the only way to fairly account for the services being provided but not adequately charged for is to allow a combined return. Therefore, taxpayer believes that the Department must look at the activities and income of the group as a whole in order to obtain an accurate reflection of income.

The Department refers to IC 6-3-2-2(l), which states:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or part of the taxpayer's business activity, if reasonable:
>
> (1) separate accounting;
> (2) the exclusion of any one (1) or more factors;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The use of the word "may" in the above language establishes that the Department is not compelled to deviate from the standard allocation formula upon request. The Department may do so if deviation from the standard formula is reasonable. Here, taxpayer has stated that the parent company is unable to properly allocate its expenses for providing services to the subsidiaries, and this inability necessitates combined filing in order to combat inaccuracies in filing. Taxpayer believes the non-arms length intercompany transactions are significant, and are not accurately reflected by the parent company's charges, and the term "significant" does not necessarily imply that the amount of the charges between the companies is considerable.

Taxpayer states that its situation appears similar to <u>ANR Pipeline</u>, in that the Department has subsequently made an alternative determination in revoking the original approval for a taxpayer to file its income tax return on a combined basis. <u>ANR Pipeline v. Indiana Department of State</u>

Revenue, 672 N.E.2d 91, (Ind. Tax 1996). That case explains, "This Court holds that the first LOF was a final determination of the Department and that the subsequent LOF was, therefore, void and legally invalid." Id. at 95. The taxpayer in that case filed a petition with the Department to file a combined return. That petition was approved and later revoked as a result of an audit.

The taxpayer in ANR Pipeline did not argue that the initial approval letter was a final determination of the Department. The Court in that case did not rule that the initial approval was a final determination of the Department. The focus of that case was the initial Letter of Finding (LOF), not the initial approval. In the instant case, taxpayer is arguing that the initial approval is the final determination of the Department. The Court's opinion in ANR Pipeline does not support taxpayer's position.

The approval letter contained the explanation that it would be revoked if there was a material error or misrepresentation. Taxpayer agrees that the approval letter stated it was granted on the contingency that if a material error or misrepresentation was discovered the ruling could be revoked, but protests that the letter did not say that it was contingent upon verification by the Audit division. IC 6-8.1-4-2 states, in part:

> (a) The division of audit may:
> (1) have full prompt access to all local and state official records;
> (2) have access, through the data processing offices of the various state agencies, to information from government and private sources that is useful in performing its functions;
> (3) inspect any books, records, or property of any taxpayer which is relevant to the determination of the taxpayer's tax liabilities;
> (4) detect and correct mathematical errors on taxpayer returns;
> (5) detect and correct tax evasion; and
> (6) employ the use of such devices and techniques as may be necessary to improve audit practices.

Since the Audit division is authorized to inspect any books, records, or property of any taxpayer which is relevant to the determination of the taxpayer's tax liabilities, an audit is an acceptable method of discovering material error or misrepresentation. The fact that the initial approval letter did not specifically state that an audit could be a method for discovering material error or misrepresentation is not determinative.

The audit discovered additional information unavailable in the initial approval process. Upon review, the Department concludes that the original approval was in error, but was not the result of a material error or misrepresentation in the application process. The appropriate remedy is for taxpayer's combined filings for the years in question to be allowed, while permission to file combined returns for years following the audit period should be denied.

The Department is unpersuaded that the standard formula for apportionment results in an injustice, arbitrary division or does not fairly attribute income to this state or others. Taxpayer has not provided documentation to deviate from standard apportionment. The decision in ANR

Pipeline does not establish that the initial approval letter was a final determination of the Department. The audit was an appropriate method for verification of the combined filing contingencies, as set forth in IC 6-8.1-4-2(a).

FINDING

Taxpayer's protest is sustained. Taxpayer's combined returns for tax years in question will be allowed. However, permission to file combined returns for tax years following the audit report in question is revoked.

II. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty. The relevant regulation is 45 IAC 15-11-2(c), which states in part:

> The department shall waive the negligence penalty imposed under [IC 6-8.1-10-2.1] if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying our or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer has demonstrated that it exercised ordinary business care and prudence in carrying out its duty to pay income tax. Therefore, taxpayer has affirmatively established reasonable cause, and the negligence penalty shall be waived.

FINDING

Taxpayer's protest is sustained.

WL/MR 010410